

UNAUDITED

Required Supplementary Stewardship Information: Social Insurance

Statement of Social Insurance

Actuarial Surplus or (Deficiency)^{a, b}

75-year Projection as of January 1, 2004

(Present values in millions of dollars)

	<u>1/1/2004</u>	<u>1/1/2003</u>	<u>1/1/2002</u>	<u>1/1/2001</u>
Estimated future income (excluding interest) ^c received from or on behalf of:				
Current participants not yet having attained retirement age	\$55,778	\$58,315	\$60,452	\$60,437
Current participants who have attained retirement age	54,882	54,491	51,137	51,202
Those expected to become participants	30,327	32,419	30,843	30,690
Subtotal—contributions and tax income for the 75-year period	140,986	145,225	142,432	142,329
Estimated future expenditures ^d :				
Current participants not yet having attained retirement age	71,803	72,976	75,781	74,453
Current participants who have attained retirement age	81,128	80,374	73,840	73,455
Those expected to become participants	13,912	13,789	12,776	12,905
Subtotal—benefit payments for the 75-year period	166,843	167,139	162,397	160,813
Estimated future excess ^e of income over expenditures	(25,857)	(21,914)	(19,965)	(18,484)

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Footnotes to the Statement of Social Insurance:

- ^a Represents combined values for the RR Account, SSEB Account, and NRRIT.
- ^b The data used reflect the provisions of the Railroad Retirement and Survivors' Improvement Act of 2001. Comparable data for years prior to 2001 by participant groupings are not available. The estimated future excess of income over expenditures under the prior law as of September 30, 2000 is \$(6,981) million.
- ^c Future income (excluding interest) includes tier 1 taxes, tier 2 taxes, income taxes on benefits, financial interchange income, advances from general revenues, and repayments of advances from general revenues. The calculations assume that all future transfers required by current law under the financial interchange will be made.
- ^d Future expenditures include benefit and administrative costs.
- ^e A closed group estimate using the projected tax rates under employment assumption II may be obtained by excluding amounts for "Those expected to become participants" listed above.

Additional Notes:

The fund balances as of 1/1/2004, 1/1/2003, 1/1/2002, and 1/1/2001 were \$26,616 million, \$22,679 million, \$20,861 million, and \$19,251 million, respectively.

Detail may not add to totals due to rounding. Employee and beneficiary status are determined as of 1/1/2003, whereas present values are as of 1/1/2004. Prior to 2003, present value categories for "Current participants not yet having attained retirement age" included those employees eligible for retirement who had not yet retired.

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Program Financing

Payroll taxes paid by railroad employers and their employees are the primary source of funding for the railroad retirement-survivor benefit programs. Railroad retirement taxes, which have historically been higher than social security taxes, are calculated, like benefit payments, on a two-tier basis. Railroad retirement tier 1 payroll taxes are coordinated with social security taxes so that employees and employers pay tier 1 taxes at the same rate as social security taxes. In addition, both employees and employers pay tier 2 taxes that are used to finance railroad retirement benefit payments over and above social security levels. Beginning with calendar year 2004, the tier 2 tax rate is based on the ratio of certain asset balances to the sum of benefit payments and administrative expenses.

Revenues in excess of benefit payments are invested to provide additional trust fund income. The NRRIT oversees most investments, including all investments in non-governmental assets. The Board of Trustees of the NRRIT is comprised of three members selected by rail labor to represent the interests of labor; three members likewise selected by rail management to represent management interests; and one independent member selected by a majority of the other six members.

Additional trust fund income is derived from the financial interchange (FI) with the social security trust funds, revenues from Federal income taxes on railroad retirement benefits, and appropriations from general treasury revenues provided after 1974 as part of a phase-out of certain vested dual benefits.

The financial interchange between the railroad retirement and social security systems is intended to put the Social Security Administration (SSA) Federal Old-Age, Survivors, and Disability Insurance (FOASI/DI) trust funds and the Centers for Medicare and Medicaid Services (CMS) Federal Hospital Insurance (FHI) trust fund in the same position they would have been had railroad employment been covered under the Social Security and Federal Insurance Contributions Acts. It follows that all computations under the FI are performed according to social security law. The amount of benefits payable under the RRA has no effect on the results.

Placing the social security trust funds in the same position they would have been had railroad employment been covered under social security since its inception involves computing the amount of social security payroll and income taxes relating to railroad employment and computing the amount of additional benefits which social security would have paid to railroad retirement beneficiaries during the same fiscal year. In the computation of the latter amount, credit is given for any social security benefits actually paid to railroad retirement beneficiaries. When benefit reimbursements exceed payroll and income taxes, the difference, with an allowance for interest and administrative expenses, is transferred from the social security trust funds to the SSEB Account. If taxes exceed benefit reimbursements (this has not happened since 1951), a transfer would be made in favor of the social security trust funds.

On a present value basis, funds provided through the FI are expected to equal \$61,117 million, or 43.3 percent of the estimated future income of \$140,986 million.

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Benefits

Full age annuities are payable at age 60 to workers with 30 years of service. For those with less than 30 years of service, reduced annuities are payable at age 62 and unreduced annuities are payable at full retirement age, which is gradually rising from 65 to 67, depending on year of birth. Disability annuities can be paid on the basis of total or occupational disability. Annuities are also payable to spouses and divorced spouses of retired workers and to widow(er)s, surviving divorced spouses, remarried widow(er)s, children, and parents of deceased railroad workers. Qualified railroad retirement beneficiaries are covered by Medicare in the same way as social security beneficiaries.

Jurisdiction over the payment of retirement and survivor benefits is shared by the RRB and SSA. The RRB has jurisdiction over the payment of retirement benefits if the employee had at least 10 years of railroad service, or five years if performed after 1995; for survivor benefits, there is an additional requirement that the employee's last regular employment before retirement or death was in the railroad industry. If a railroad employee or his or her survivors do not qualify for railroad retirement benefits, the RRB transfers the employee's railroad retirement credits to SSA, where they are treated as social security credits.

Program Finances and Sustainability

The RRB must submit to the President and the Congress a report on the actuarial status of the Railroad Retirement system. Projections are made of the various components of income and outgo under three employment assumptions.

The Statement of Social Insurance presents an actuarial analysis of the financial position of the RR System as of January 1, 2004. The figures in the table are based on the 2004 Section 502 actuarial valuation extended through calendar year 2078. The present values in the table are based on estimates of contributions and expenditures through the year 2078. The estimates include contributions and expenditures related to future participants as well as to former and present railroad employees. The present values are computed on the basis of economic and demographic assumptions and employment assumption II, the intermediate employment assumption, as used in the 2004 Section 502 actuarial valuation. Under employment assumption II, starting with an average 2003 employment of 223,000, (1) railroad passenger employment is assumed to remain level at 42,000, and (2) the employment base, excluding passenger employment, is assumed to decline at a constant annual rate of 3.0 percent for 25 years, at a reducing rate over the next 25 years, and remain level thereafter.

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Required Supplementary Stewardship Information: Actuarial estimates of the long-range financial condition of the Railroad Retirement program are presented here. Throughout this section, the following terms will generally be used as indicated:

- Income: sources of income are payroll taxes, income taxes, interest income, and financial interchange transfers.
- Income excluding interest^a : income, as defined above, excluding the interest income from assets of the trust fund.
- Expenditures: benefit payments and administrative expenses.
- Cashflow: either (1) income excluding interest or (2) expenditures, depending on the context, expressed in nominal dollars.
- Net Cashflow: income excluding interest less expenditures, expressed in nominal dollars.

All estimates in this section are based on the intermediate assumptions in the 2004 Section 502 actuarial valuation. The statement presented on page 68 and the required supplementary information below are derived from estimates of future income and expenditures based on these assumptions, the RRA, and the Railroad Retirement Tax Act. This information includes:

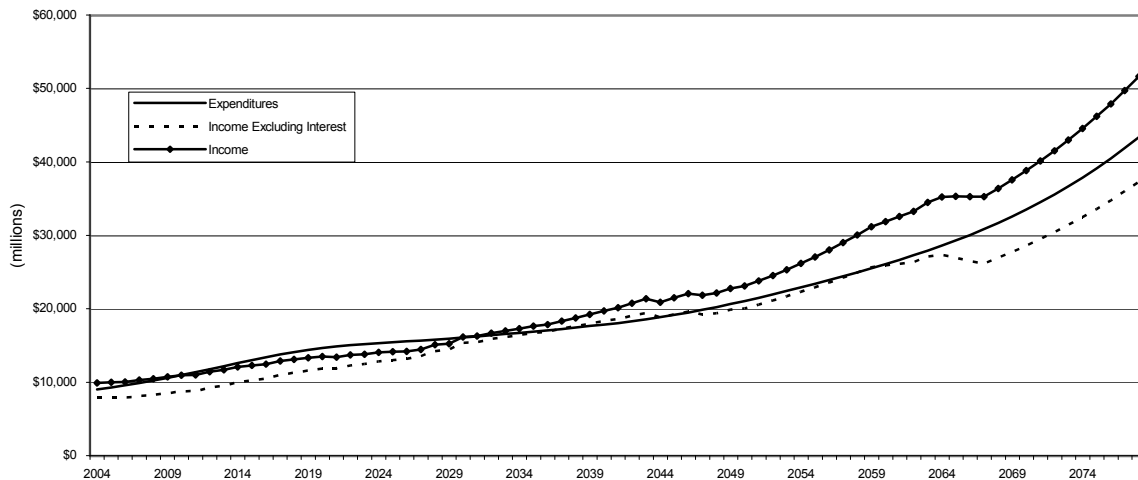
- (1) actuarial present values of future estimated expenditures for and estimated income from, or on behalf of, current and future program participants;
- (2) estimated annual income excluding interest and expenditures in nominal dollars and as a percentage of taxable payroll.
- (3) the ratio of estimated annuitants to estimated full-time employees, showing the relationship between the program's benefit recipients and taxpayers; and
- (4) an analysis of the sensitivity of the projections to changes in selected assumptions, which is included in recognition of the inherent uncertainty of those assumptions.

Estimates are generally based on a 75-year projection period. Estimates extending far into the future are inherently uncertain, with uncertainty greater for the more distant years.

^a References to interest income in this section may be considered as referring to total investment income including dividends and capital gains.

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Chart 1: Estimated Income and Expenditures



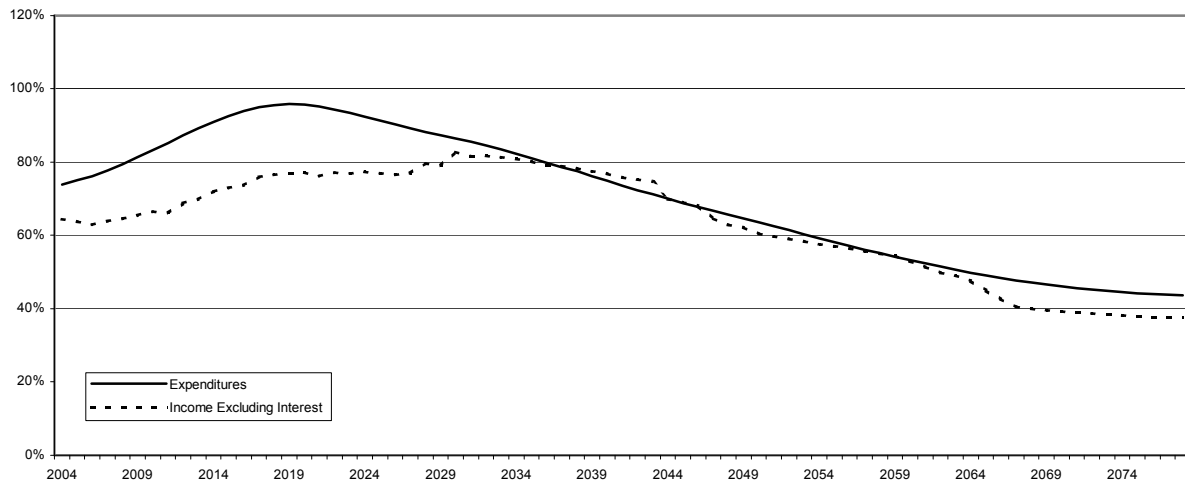
Cashflow Projections – Chart 1 shows actuarial estimates of Railroad Retirement annual income, income excluding interest, and expenditures for 2004-2078 in nominal dollars. The estimates are for the open-group population, which includes all persons projected to participate in the Railroad Retirement program as railroad workers or beneficiaries during the period. Thus, the estimates include payments from, and on behalf of, those who will be employed by the railroads during the period as well as those already employed at the beginning of the period. They also include expenditures made to, and on behalf of, such workers during that period.

As Chart 1 shows, annual expenditures begin to exceed annual income in 2010. This continues for two decades, but by 2030 income is once again greater than expenditures. This remains true throughout the remainder of the projection period. Without investment income, however, annual expenditures are almost always greater than annual income, except for the periods 2037-2043, 2045-2046, and 2059. Reasons for this pattern include participant demographics, the assumed drop in railroad employment, and the automatic tier 2 tax rate adjustment mechanism. The combined balance of the NRRIT, RR Account, and SSEB Account never becomes negative largely because (i) a sufficient balance exists at the beginning of the projection period and (ii) tier 2 tax rates respond automatically to changing account balances.

Percentage of Taxable Payroll – Chart 2 shows estimated annual income excluding interest and expenditures for the Railroad Retirement program expressed as percentages of taxable payroll. Benefits and administrative expenses as a percentage of payroll increase through 2019 primarily due to the anticipated retirement of a large percentage of the current workforce combined with the projected decline in railroad employment. Except for the income from tier 1 payroll taxes, the sources of income vary as a percentage of payroll.

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Chart 2: Estimated Railroad Retirement Income Excluding Interest and Expenditures as a Percent of Taxable Tier 2 Payroll



Sensitivity Analysis -- The projections of the future financial status of the Railroad Retirement program depend on many economic and demographic assumptions including rail employment, inflation, wage increase, investment return, age retirement, disability retirement, withdrawal, active service mortality, beneficiary mortality, total termination, probability of spouse, remarriage, family composition, disability freeze, service patterns, and salary scales. Because perfect long-range projections are impossible, this section is included to illustrate the sensitivity of the long-range projections to changes in certain key assumptions that have the greatest impact on the results. All present values are calculated as of January 1, 2004, and are based on estimates of income and expenditures during the projection period 2004-2078.

Employment: Average employment in the railroad industry has been in decline for some years. This decline is expected to continue. Since employment is a key consideration, projections of income and expenditures using three different employment assumptions have been made. The Statement of Social Insurance uses employment assumption II, the intermediate assumption, but this section compares results under the three assumptions. For all three cases, the average employment for the year 2003 is equal to 223,000. Employment assumptions I and II, based on a model developed by the Association of American Railroads, assume that (1) passenger employment will remain at the level of 42,000, and (2) the employment base, excluding passenger employment, will decline at a constant annual rate (1.5 percent for assumption I and 3.0 percent for assumption II) for 25 years, at a reducing rate over the next 25 years, and remain level thereafter. Employment assumption III differs from employment assumptions I and II by assuming that (1) passenger employment will decline by 500 per year until a level of 35,000 is reached and then remain level, and (2) the employment base, excluding passenger employment, will decline at a constant annual rate of 4.5 percent for 25 years, at a reducing rate over the next 25 years, and remain level thereafter. Employment assumptions I, II, and III are intended to provide an optimistic, moderate, and pessimistic assumption, respectively.

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Under the first two employment assumptions, no cashflow problems occur throughout the entire period. Under the third employment assumption, cashflow problems occur in 2026. Table 1 shows the excess of assets and the present value of income over the present value of expenditures for the three employment assumptions.

Table 1
Excess of Assets and Present Value of Income over Present Value of Expenditures for Three Employment Assumptions, 2004-2078
(in millions)

Employment Assumption	<u>I</u>	<u>II</u>	<u>III</u>
Present Value	\$936	\$759	\$(1,759)
Average Tier 2 tax rate ^a	16.3%	18.4%	19.6%

^aAverage combined employer/employee tier 2 tax rate is calculated by dividing the present value of tier 2 taxes by the present value of tier 2 payroll. Beginning in 2004, tier 2 tax rates vary based on a ratio of assets to the sum of benefits and administrative expenses. Tier 1 tax rates remain the same as for social security and are not affected by employment assumptions.

Chart 3a shows the combined balance of the accounts under each of the three employment assumptions. Note that in 2026, the combined account balance becomes negative under employment assumption III.

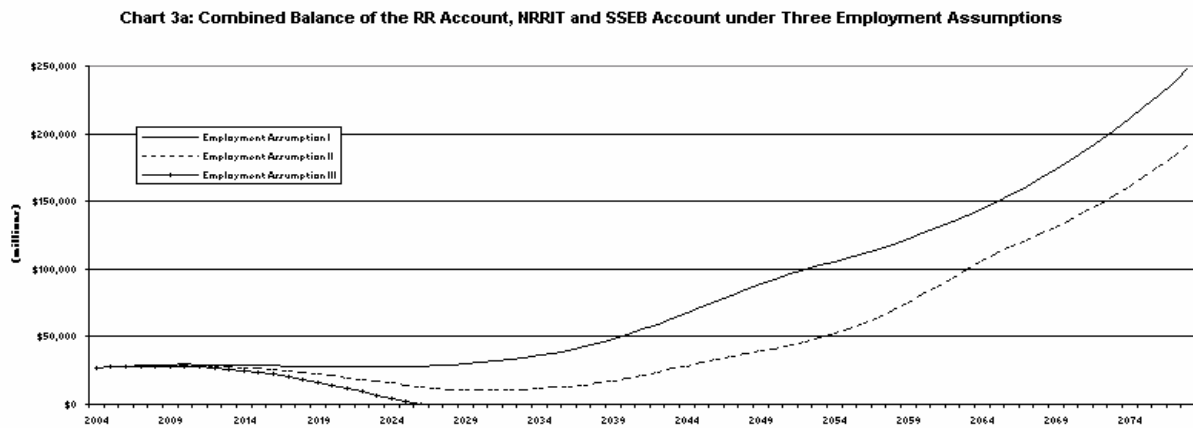
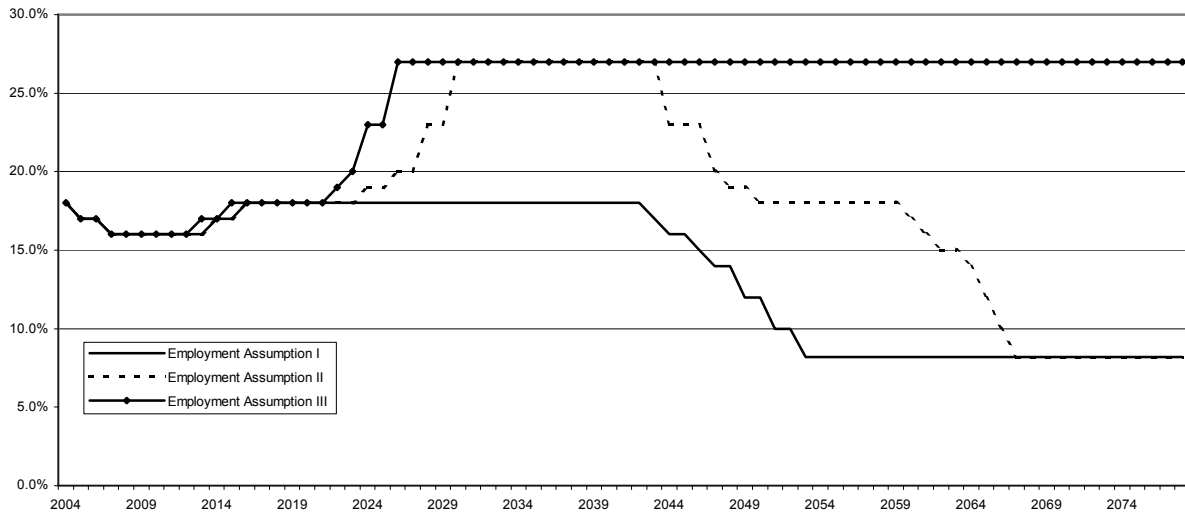


Chart 3b shows the tier 2 tax rate under these employment assumptions. The tax rate reaches the minimum in 2053 under employment assumption I but not until 2067 under employment assumption II. Under employment assumption III, the tax rate reaches the maximum in 2026 and remains at that level throughout the remainder of the projection period because the combined account balances are negative.

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Chart 3b: Tier 2 Tax Rate under Three Employment Assumptions



Under the provisions of the RRSIA, the tier 2 tax rate for each year is determined by the average account benefits ratio, which is the average for the ten most recent fiscal years of the ratio of fair market value of assets in the RR Account and NRRIT (and for years before 2002, the SSEB Account) to the total benefits and administrative expenses paid from the RR Account and the NRRIT. Therefore, the tier 2 tax rate will be affected by employment assumption. The tier 2 tax rate adjustment mechanism promotes but does not guarantee solvency. The tier 1 tax rate does not vary by employment assumption.

Interest rates: Since investments may include non-governmental assets such as equity and debt securities as well as governmental securities, it is worthwhile to examine the effects of future rates of investment return. In addition to the interest rate of 8 percent used for our projections, we show the effect on the combined accounts of an interest rate of 4 percent and an interest rate of 12 percent. Table 2 shows the excess of assets and the present value of income over the present value of expenditures for the three interest rate assumptions. If the tier 2 tax rate were fixed, the actuarial surplus would increase with increasing investment return. However, the tier 2 tax rate adjusts to changing account balances, resulting in the highest average tax rate under the 4 percent scenario and the lowest average tax rate under the 12 percent scenario. Under the 8 percent scenario, the tax rate adjustment mechanism keeps the system in close actuarial balance. Under the 12 percent scenario, the tax rate is limited to a minimum value, resulting in a higher surplus. Under the 4 percent scenario, the tax rate reaches a maximum value and then remains at that value longer than is needed, resulting in the highest actuarial surplus.

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Table 2
Excess of Assets and Present Value of Income over Present Value of Expenditures for
Three Interest Rate Assumptions, 2004-2078
(in millions)

Interest Rate Assumption	<u>4%</u>	<u>8%</u>	<u>12%</u>
Present Value	\$7,296	\$759	\$3,026
Average Tier 2 tax rate	22.8%	18.4%	13.8%

Chart 4a shows the combined account balance under the three interest rate assumptions for the projection period. At a 4 percent interest rate, the account balance becomes negative in 2022 and remains so until 2055, at which time it begins to increase again. With an 8 percent interest rate, the account balance increases through 2009, then decreases, reaching a minimum in 2029, and increases thereafter. A 12 percent interest rate results in a combined balance that increases throughout the projection period. Although the 4 percent scenario shows the lowest account balance at the end of the projection period, the concurrent use of a 4 percent discount rate results in the highest surplus on January 1, 2004.

Chart 4a: Combined Balance of the RR Account, NRRIT and SSEB Account under Three Interest Assumptions

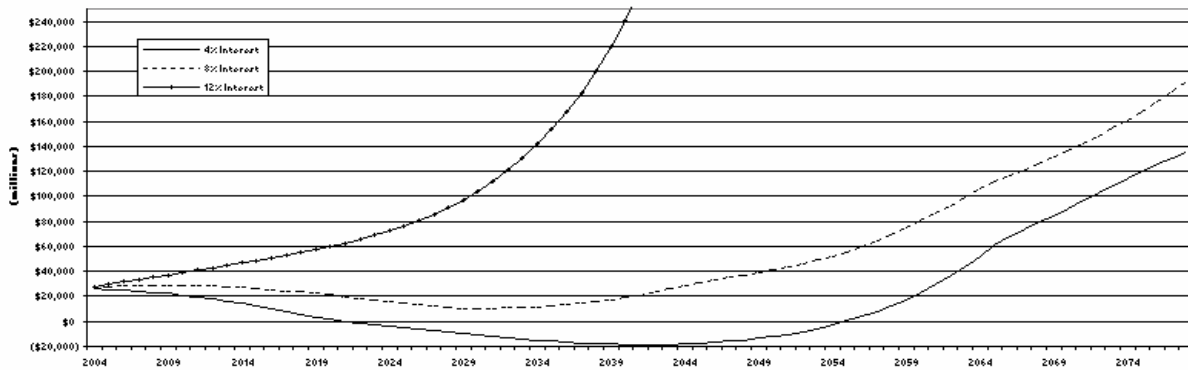
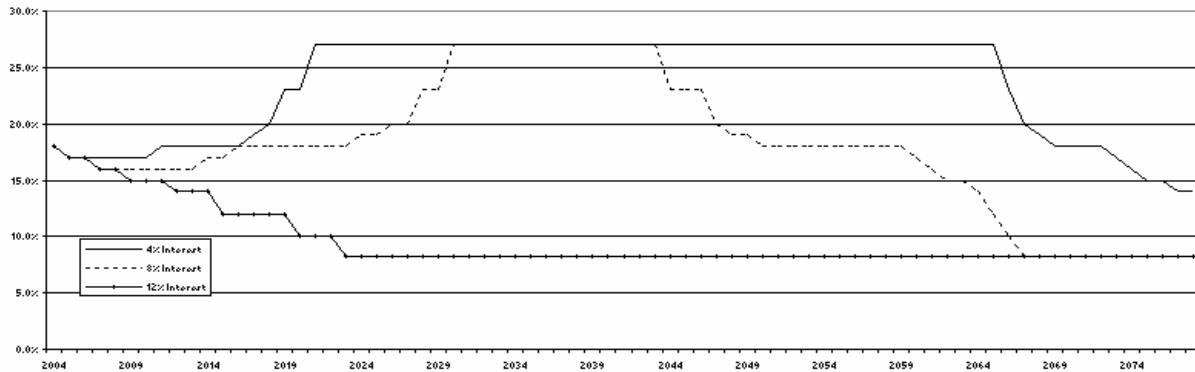


Chart 4b shows the tier 2 tax rate under the same three interest assumptions. With a 4 percent interest rate, the maximum tier 2 tax rate applies throughout much of the projection period, from 2021 until 2065. Even with the 8 percent interest rate, the maximum tax rate will be paid from 2030 until 2043. On the other hand, with a 12 percent interest rate, the maximum tax rate is never applicable, and the minimum tax rate is paid beginning in 2023. As mentioned above, the tier 2 tax rate is determined based on the ratios of asset values to benefits and administrative expenses, so it will be affected by investment return, but tier 1 tax rates will not.

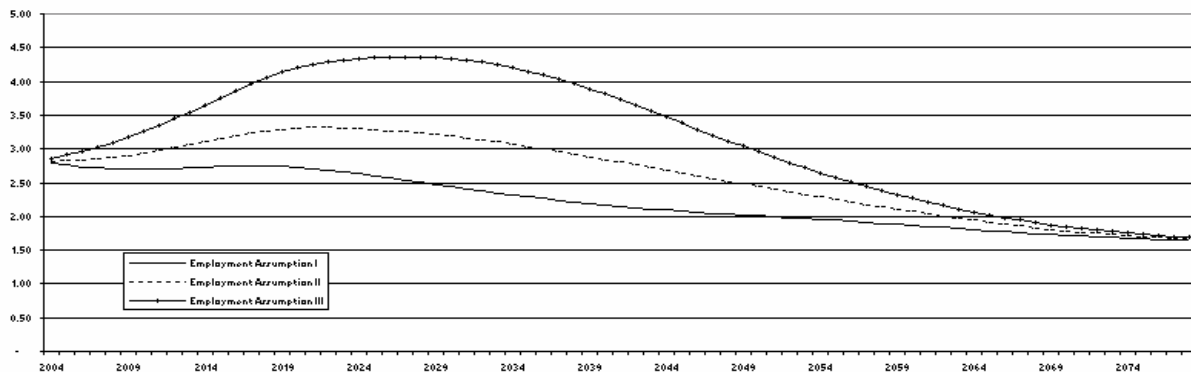
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Chart 4b: Tier 2 Tax Rate under Three Interest Assumptions



Ratio of Beneficiaries to Workers: Chart 5 shows the estimated number of annuitants per full-time employee under all three employment assumptions. The average number of annuitants per employee for employment assumption I is highest in 2004. For assumptions II and III, the ratio is highest in 2022 and 2027, respectively. For all three employment assumptions, the average number of annuitants per employee declines to around 1.7 by the end of the projection period. The convergence in number of annuitants per employee at the end of the projection period results primarily from level employment projected in the latter years under all three employment assumptions.

Chart 5: Average Number of Annuitants per Full-Time Employee



Railroad Retirement Assumptions

The estimates used in this presentation are based on the assumption that the program will continue as presently constructed. They are also based on various economic, employment, and other actuarial assumptions. The employment assumptions were described above. The ultimate economic assumptions are an 8 percent interest rate, a 3 percent annual increase in the cost of living, and a 4 percent annual wage increase. Actuarial assumptions are those published in the "Twenty-Second Actuarial Valuation of the Assets and Liabilities Under the Railroad Retirement Acts as of December 31, 2001 with Technical Supplement," as updated in the 2004 Section 502 Report. The Section 502 Report is an annual report on the actuarial status of the Railroad Retirement System required by law.

REQUIRED SUPPLEMENTARY INFORMATION
RAILROAD RETIREMENT BOARD
INTRAGOVERNMENTAL ACTIVITY AND BALANCES
FISCAL YEAR 2004

ASSETS:

Trading Partner	Fund balance with Treasury	Investments	Accounts Receivable	Total
Treasury (20)	\$39,053,767	\$1,304,375,721	\$0	\$1,343,429,488
Treasury (99)	0	0	0	0
SSA (28)	0	0	3,712,448,705	3,712,448,705
DOL (16)	0	0	86,208,934	86,208,934
Total	\$39,053,767	\$1,304,375,721	\$3,798,657,639	\$5,142,087,127

LIABILITIES:

Trading Partner	Accounts Payable	Debt	Other	Total
Treasury (20)	\$155,433	\$3,026,669,568	\$0	\$3,026,825,001
Treasury (99)	0	0	106,238	106,238
CMS (75)	421,200,000	0	0	421,200,000
DOL (16)	0	0	371,248	371,248
SSA (28)	0	0	49,957	49,957
OPM (24)	0	0	414,464	414,464
GSA (47)	75,167	0	0	75,167
Total	\$421,430,600	\$3,026,669,568	\$941,907	\$3,449,042,075

BUDGETARY FINANCING SOURCES - UNEXPENDED APPROPRIATIONS:

Trading Partner	Appropriations Received	Total
Treasury (99)	\$554,150,000	\$554,150,000

BUDGETARY FINANCING SOURCES - CUMULATIVE RESULTS OF OPERATIONS (NOTE 1):

Trading Partner	Appropriations Used	Non-Exchange Revenue (Note 2) Payroll Taxes	Interest	Gain(Loss) on Disposition of Assets	Total
Treasury (20)	\$0	\$0	\$45,895,562	\$0	\$45,895,562
Treasury (99)	552,348,151	4,416,802,889	0	0	4,969,151,040
Total	\$552,348,151	\$4,416,802,889	\$45,895,562	\$0	\$5,015,046,603

OTHER FINANCING SOURCES:

Trading Partner	Transfers In/Out Without Reimbursement	Imputed Financing Costs	Total
DOL (16)	\$129,810,341	\$0	\$129,810,341
OPM (24)	0	9,891,651	9,891,651
SSA (28)	3,855,543,000	0	3,855,543,000
CMS (75)	(434,280,000)	0	(434,280,000)
Total	\$3,551,073,341	\$9,891,651	\$3,560,964,993

PROGRAM COSTS:

Trading Partner	Interest	Salaries and Expenses	Imputed Cost	Reimbursements	Total
Treasury (20)	\$170,529,722	\$980,478	\$0	\$0	\$171,510,200
Treasury (99)	0	4,904,359	0	0	4,904,359
COM(13)	0	440	0	0	440
DOI(14)	0	500	0	0	500
DOJ (15)	0	0	0	0	0
DOL (16)	0	186,308	0	0	186,308
VA(36)	0	25,403	0	0	25,403
CMS (75)	0	28,852	0	(5,693,915)	(5,665,063)
OPM (24)	0	11,617,679	9,891,651	0	21,509,331
USPS (18)	0	819,647	0	0	819,647
LOC(03)	0	(1,005)	0	0	(1,005)
GPO (04)	0	121,648	0	0	121,648
DOD	0	4,562	0	0	4,562
HS (70)	0	975	0	0	975
SBA (73)	0	(10,000)	0	0	(10,000)
GSA (47)	0	7,015,048	0	0	7,015,048
Total	\$170,529,722	\$25,694,896	\$9,891,651	(\$5,693,915)	\$200,422,354

EARNED REVENUES NOT ATTRIBUTED TO PROGRAM:

Trading Partner	Other Revenue	Total
DOL (16)	\$1,953	\$1,953
NMB (95)	(36,967)	(36,967)
Total	(\$35,014)	(\$35,014)

Note 1: Amount does not include the transfers to the NRRIT for \$586,000,000 or the transfers in from the NRRIT for \$1,564,044,000.
Note 2: Amounts do not include other non-exchange revenue items of \$27,067 and carriers' refunds and interest of (\$241,303).

RAILROAD RETIREMENT BOARD
DISAGGREGATE OF BUDGETARY RESOURCES
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2004

Budgetary Resources:	COMBINED RAILROAD RETIREMENT PROGRAM	COMBINED RAILROAD UNEMPLOYMENT AND SICKNESS INSURANCE PROGRAM	LIMITATION ON THE OFFICE OF INSPECTOR GENERAL	COMBINED TOTALS	INTER-FUND ELIMINATIONS	CONSOLIDATED TOTALS
Appropriations Received	\$10,807,110,701	\$185,506,856	\$0	\$10,992,617,557	(\$435,000,000)	\$10,557,617,557
Net Transfers	9,375,632	(15,746,120)	6,370,488	0	0	0
Unobligated Balance, Beginning of Period	14,185,249	0	304,648	14,489,897	0	14,489,897
Spending Authority From Offsetting Collections						
Earned	6,870,566	32,654,176	274	39,525,016	(529,559)	38,995,457
Recoveries of Prior Year Obligations	1,016,649	0	77,300	1,093,949	0	1,093,949
Temporarily Not Available Pursuant to Public Law	(498,373,352)	(86,837,023)	0	(585,210,375)	0	(585,210,375)
Permanently Not Available	(1,347,242)	0	0	(1,347,242)	0	(1,347,242)
Total Budgetary Resources	\$10,338,838,203	\$115,577,889	\$6,752,710	\$10,461,168,802	(\$435,529,559)	\$10,025,639,243
Status of Budgetary Resources:						
Obligations Incurred	\$10,323,624,328	\$115,577,889	\$6,544,089	\$10,445,746,306	(\$435,529,559)	\$10,010,216,747
Unobligated Balance	1,314,271	0	19,908	1,334,179		1,334,179
Unobligated Balance Not Available	13,899,605	0	188,712	14,088,317		14,088,317
Total Status of Budgetary Resources	\$10,338,838,204	\$115,577,889	\$6,752,709	\$10,461,168,802	(\$435,529,559)	\$10,025,639,243
Relationship of Obligations to Outlays:						
Obligated Balance, Net, Beginning of Period, as Adjusted	\$813,709,949	\$4,723,632	\$345,857	\$ 818,779,438	\$0	\$818,779,438
Obligated Balance, Net, End of Period:						
Accounts Receivable	(96,122)	0	0	(96,122)	0	(96,122)
Undelivered Orders	(3,292,161)	0	(245,719)	(3,537,880)	0	(3,537,880)
Accounts Payable	(818,324,856)	(4,214,058)	(94,745)	(822,633,659)	0	(822,633,659)
Outlays:						
Disbursements	10,314,880,074	116,083,079	6,472,181	10,437,435,334	(435,529,559)	10,001,905,775
Collections	(6,944,762)	(32,649,792)	(274)	(39,594,828)	529,559	(39,065,269)
Subtotal	10,307,935,312	83,433,287	6,471,907	10,397,840,506	(435,000,000)	9,962,840,506
Less: Offsetting Receipts	3,856,263,000	0	0	3,856,263,000	0	3,856,263,000
Net Outlays	\$6,451,672,312	\$83,433,287	\$6,471,907	\$6,541,577,506	(\$435,000,000)	\$6,106,577,506



UNITED STATES RAILROAD RETIREMENT BOARD

OFFICE OF INSPECTOR GENERAL

To the Board Members:

The following report presents the results of the Office of Inspector General's (OIG) audits of the financial statements of the Railroad Retirement Board (RRB) as of and for the fiscal years ending September 30, 2004 and 2003.

Opinion on the Financial Statements

The RRB's financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, the financial position of the RRB, its consolidated net cost of operations and change in net position; combined budgetary resources; and reconciliation of net cost to budgetary resources as of and for the fiscal years ending September 30, 2004 and 2003.

Emphasis of Matters

The RRB's financial statements include, as required supplementary stewardship information, a statement of social insurance and related disclosures for the railroad retirement program. The statement and disclosures include cash flow projections and other estimates prepared to comply with the specific requirements established for Federal financial reporting. This supplementary information presents, in some respects, a different perspective on program solvency from the actuarial forecast included in management's discussion and analysis.

The Railroad Retirement and Survivors' Improvement Act of 2001 established the National Railroad Retirement Investment Trust (NRRIT) and provided for the transfer of funds in excess of benefit payment requirements to the NRRIT for investment. Neither the assets held by the NRRIT, nor any related income, are reported in the RRB's consolidated financial statements although they are included in the estimates and projections presented in the Statement of Social Insurance, and related disclosures, for the Railroad Retirement Act program and discussed elsewhere in the Performance and Accountability Report.

Transfers-in from the Social Security Administration's Old Age and Survivor, and Disability Insurance trust funds and transfers-out to the Federal Health Insurance Trust Fund represented \$3.4 billion (net), or approximately 40%, of the nearly \$ 8.6 billion in total financing sources reported on the statement of changes in net position, excluding transfers-in/ transfers-out to the NRRIT.

Report On Internal Control

Our evaluation of internal controls disclosed one material weakness and one reportable condition.¹ The details of our findings follow. However, the objective of our audit was not to provide an opinion on internal control. Accordingly, we do not express such an opinion.

Although not considered to be material weaknesses or reportable conditions, we have reported other matters involving internal control and its operation to RRB Management in a separate letter dated October 25, 2004.

Material Weakness - Information Security

During FY 2004, the OIG evaluated information security pursuant to the provisions of the Federal Information Security Management Act. Our reviews disclosed continued weaknesses in many areas of the RRB's information security program. Significant deficiencies in program management and access controls make the agency's information security program a source of material weakness in internal control.

The RRB has undertaken the job of strengthening information security and has implemented many corrective actions recommended by the OIG and other technical specialists. However, the agency has not completed the corrective action needed to eliminate the previously reported deficiencies in training and access controls that were the basis for the OIG's original finding of material weakness.

The details of our recent findings with respect to information security are presented in OIG audit report #04-11, "Fiscal Year 2004 Evaluation of Information Security at the Railroad Retirement Board," September 30, 2004.

Reportable Condition – Compliance

The RRB's debt recovery program was not updated for changes to agency regulations that impact interest charges on program debt. As a result, some debtors were overcharged interest. Although this non-compliance would not have a material monetary impact in the aggregate, it indicates that the RRB does not have adequate controls to ensure that changes to laws and regulations are fully

¹ A material weakness is a reportable condition that precludes the entity's internal controls from providing reasonable assurance that material misstatements in the financial statements would be prevented or detected on a timely basis. Reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation of internal control that could adversely affect the RRB's ability to meet the objectives described in this report.

implemented. Agency operations should react timely to changes in laws and regulations.

The Code of Federal Regulations (CFR) provides for the assessment of interest after the expiration of the period during which debtors may request reconsideration of the agency's debt recovery decision and/or waiver of recovery. Effective December 17, 2002, amendments to the CFR changed the period during which debtors could request reconsideration and/or waiver of recovery from 30 to 60 days. The automated system that supports debt management was not updated for the corresponding change to the date from which interest accrues on delinquent debt.

We have recommended that the Bureau of Law review and strengthen controls to ensure full implementation of changes to laws and regulations.

Compliance with Laws and Regulations

Our tests of compliance with selected provisions of laws and regulations disclosed two instances of non-compliance that are reportable under U.S. generally accepted government auditing standards or Office of Management and Budget (OMB) guidance as described below.

Our tests of interest on program debt disclosed that the agency had not implemented a change to the Code of Federal Regulations (CFR) that would have delayed interest charges on delinquent debt by an additional 30 days under 20 CFR section 200.7(b)(2).

In addition, the RRB has not yet implemented provisions of the Railroad Retirement and Survivors Improvement Act of 2001 that require railroad retirement benefits be disbursed by a qualified non-governmental financial institution, rather than the department of the Treasury. Agency management is currently seeking legislative relief from this requirement.

The results of our tests of compliance disclosed no other instances of noncompliance with laws and regulations that are required to be reported under government auditing standards or OMB guidance. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

Consistency of Other Information

The RRB's Management's Discussion and Analysis, required supplementary information, required supplementary stewardship information, and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We did not audit and do not express an

opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with RRB officials. Based on this limited work, we found no material inconsistencies with the financial statements or nonconformance with OMB guidance.

Objectives, Scope, and Methodology

RRB management is responsible for (1) preparing the annual financial statements in conformity with U.S. generally accepted accounting principles, (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met, and (3) complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles and (2) management maintained effective internal control that provides reasonable, but not absolute, assurance that the following objectives were met.

- Financial reporting: Transactions are properly recorded, processed and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles and assets are safeguarded against loss from unauthorized acquisition, use or disposition.
- Compliance with laws and regulations: Transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and governmentwide policies identified by OMB audit guidance.

We are also responsible for (1) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (2) performing limited procedures with respect to certain other information appearing in these annual financial statements. In order to fulfill these responsibilities, we:

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the financial statements;

- obtained an understanding of internal controls related to financial reporting and compliance with laws and regulation;
- obtained an understanding of the recording, processing, and summarizing of performance measures as reported in Management's Discussion and Analysis;
- tested relevant internal controls over financial reporting and compliance, and evaluated the design and operating effectiveness of internal controls;
- considered the process for evaluating internal controls and financial management systems under the FMFIA;
- tested compliance with selected provisions of the following laws and regulations:
 - Anti-Deficiency Act, as amended;
 - Prompt Payment Act;
 - Pay and Allowance System for Civilian Employees;
 - Provisions Governing Claims of the United States Government, including provisions of the Debt Collection Improvement Act;
 - laws providing for the appropriation of funds for the administration of the programs mandated by the Railroad Retirement and the Railroad Unemployment Insurance Acts, including the payment of benefits; and
 - Railroad Retirement and Railroad Unemployment Improvement Acts.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FMFIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to those controls over financial reporting and compliance with laws and regulations. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate.

We did not test compliance with all laws and regulations applicable to the RRB. We limited our tests of compliance to those laws and regulations that had a direct and material effect on the financial statements or that were required to be tested by OMB audit guidance that we deemed applicable to the financial statements for the fiscal years ended September 30, 2004, and 2003.

We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

We performed our work in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

RRB Management's Comments

RRB management was provided with a draft of this report and had no comment.

A handwritten signature in black ink, reading "Martin J. Dickman". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Martin J. Dickman
Inspector General

October 25, 2004

SERIOUS MANAGEMENT CHALLENGES IDENTIFIED BY THE RAILROAD RETIREMENT BOARD'S OFFICE OF INSPECTOR GENERAL

The Office of Inspector General (OIG) is monitoring agency performance in addressing the most serious challenges facing the agency.

- Control Environment
- Asset Stewardship
- Managing For Change
- Information Technology Security

Control Environment

The OIG has continuing concerns about the effectiveness of the Railroad Retirement Board's (RRB) overall control environment. We have long believed that the agency's basic structure, a three-member Board, rather than a single chief executive, cannot provide the kind of proactive top-down leadership that the Railroad Retirement Act (RRA) and Railroad Unemployment Insurance Act (RUIA) programs require to meet the challenges of the coming years.

We have repeatedly questioned the efficiency of an organizational structure, which, no matter how it has been organized and re-organized over the years, fosters an emphasis on the issues and objectives of its various operating units at the expense of larger organizational goals.

This structure fosters a cumbersome administrative process that adversely impacts the agency's ability to rise to the challenges it faces in asset stewardship, managing for change and implementing effective security in a changing information technology environment.

Asset Stewardship

The OIG questions the adequacy of oversight provided to the National Railroad Retirement Investment Trust (NRRIT). As of June 30, 2004, the NRRIT reported RRA program investments in excess of \$25 billion, yet the RRB's three-member Board has accepted a largely passive relationship with that entity.

Although, the NRRIT was created as a non-governmental entity, the agency has a right to bring civil action against the NRRIT if any provisions of the RRA are violated. However, the RRB does not obtain sufficient information to assess whether the Trustees are fulfilling their fiduciary responsibilities under the Act.

In addition, the NRRIT has not been required to consolidate financial reporting with the RRB. The OIG believes that this separate financial reporting arrangement, while adhering to the letter of the law, undermines the effectiveness of the overall Federal initiative towards financial accountability. A reader cannot be expected to obtain a complete picture of the financial status of a program whose assets are not reported along side its results of operations and actuarial forecast. This effect will be exacerbated when the actuarial projections that are currently presented as Required Supplementary Stewardship Information become subject to audit in future years.

Managing Change

The OIG has serious concerns about the continued viability of the RRB as a business entity. The agency serves a rapidly declining customer base administering benefit programs that are redundant of other Federal social insurance programs. During FY2003, the RRB paid RRA benefits to 666,000 individuals, a drop of 24% in just 10 years. During the same period, the average number of workers supporting the program dropped 16% to 223,000.

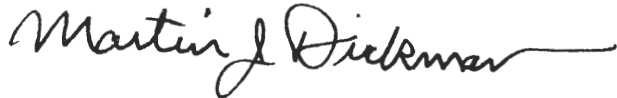
The RRB's role as stewards of the Federal health and welfare programs for the railroad community has been eroded significantly. The retirement program has long depended on annual cash transfers from the Social Security Administration to ensure its solvency while the creation of the NRRIT stripped the agency of most of its responsibility for RRA investments. In addition, OMB recently directed the agency to implement financial reporting changes that classify the cash and investments of the RUIA program as assets of the Department of Labor which had already assumed responsibility for RUIA stewardship reporting.

The OIG has, for many years, urged the agency to transform itself to meet the challenges of providing efficient service delivery to shrinking worker and beneficiary populations. Agency management has generally disregarded our recommendations for reinventing the agency's service delivery model.

Information Technology Security

The agency's information services are experiencing increasing demands from its need to service existing data processing operations and innovate with new mainframe and desktop applications while at the same time meeting national objectives to deliver service to the public electronically.

The OIG has cited the agency with material weaknesses due to significant deficiencies in access controls in both the mainframe and end-user computing environments and in the training provided to staff with significant security responsibilities. Agency management has acknowledged the material weaknesses reported by the OIG and has planned action to address them. However, the challenge of developing and maintaining a strong information security position will strain the agency's already compromised control environment.

A handwritten signature in black ink, reading "Martin J. Dickman", followed by a long horizontal flourish.

Martin J. Dickman
Inspector General

September 22, 2004

Management's Comments

The Inspector General has presented four serious management challenges that he believes face the RRB. Three of these challenges are similar to issues raised by the Inspector General and presented in the Fiscal Year 2003 Performance and Accountability Report and the fourth, Control Environment, is a repeat of a concern he has raised on numerous occasions with respect to the structure of the RRB. RRB management respectfully disagrees with the Inspector General that the issues he has presented represent serious management challenges. Our comments on each issue are set out below.

Control Environment

The Inspector General's concerns in this area start with the statutorily mandated structure of the RRB as an agency headed by a three-member Board. He suggests that the lack of a single chief executive results in an inability to "...provide the kind of proactive top-down leadership that the Railroad Retirement Act (RRA) and Railroad Unemployment Insurance Act (RUIA) programs require to meet the challenges of the coming years." The Inspector General also suggests that the organizational structure of RRB below the agency head fosters an emphasis on individual organizations rather than agency goals and objectives.

The strong performance information provided in the Fiscal Year 2004 Performance and Accountability Report as well as the information provided in reports for previous years does not reflect an agency that is not well run. In fact, the RRB's Performance and Accountability Reports show just the opposite to be true. Agency goals reflect the agency's focus on service delivery to our customers and on the roles played by the various organizations in achieving those goals. Our performance goals and objectives are demanding, but, over the years, we have met or nearly met all of the goals and objectives set forth in our annual performance plans.

Immediately below the three-member Board that heads the RRB is the agency's six-member Executive Committee. This Committee, under the Chairmanship of the agency's Senior Executive Officer, oversees the day-to-day operations of the agency. The Executive Committee is comprised of the heads of the major RRB organizations, and the members of the Committee work together closely to see that agency goals, rather than individual organization issues, are paramount in day-to-day and long-range decision-making.

Asset Stewardship

The Inspector General suggests that the RRB does not provide sufficient oversight of the activities of the NRRIT and that the agency lacks information needed to assess whether the NRRIT is fulfilling its responsibilities with respect to investment of railroad retirement trust funds. Neither of these suggestions is accurate.

The responsibilities of the NRRIT and the RRB with respect to investment of railroad retirement funds are very clearly set out in the RRA. The NRRIT has responsibility for investment of funds, and the RRB has responsibility to ensure that the NRRIT and its officers and staff fulfill their statutory responsibilities. Audit and reporting requirements with respect to NRRIT activities are also very clearly set out in the RRA.

In addition to the statutory requirements for audits and reporting, the NRRIT, RRB, Treasury, and OMB entered into a multi-party Memorandum of Understanding (MOU) that provides in greater detail the information that the NRRIT is required to furnish to various Federal agencies,

including the RRB. The various reports required by the statute and the MOU provide information needed by the RRB to fulfill its statutory responsibilities. In addition, the agency's General Counsel meets on a monthly basis with the NRRIT's Chief Investment Officer and the Counsel to the Trust to discuss NRRIT operations and activities. Finally, the three-member Board that heads the RRB meets at least twice a year with the NRRIT to address issues that arise between the NRRIT and the RRB.

The RRB is anything but passive in fulfilling its statutory responsibilities with respect to the NRRIT.

The Inspector General also raises the issue that the NRRIT has not been required to consolidate financial reporting with the RRB. He states that this separate financial reporting arrangement, while adhering to the letter of the law, undermines the effectiveness of the overall Federal initiative towards financial accountability. We disagree with this conclusion. The NRRIT provides financial information that is included in the annual government-wide Financial Report. In addition, the RRA specifically requires the NRRIT to annually engage an independent, qualified public accountant to audit the NRRIT's financial statements, to submit an annual management report to the Congress no later than 180 days after the end of the NRRIT's fiscal year, and to provide a copy of the management report to the President, RRB, and OMB when it is submitted to the Congress. Finally, it should be noted that the OIG raised this issue earlier this year and, in response to that office's suggestion, on June 7, 2004, we wrote to the FASAB seeking its guidance. FASAB's Executive Director has advised us that she has assigned the matter to one of her staff for review.

Managing Change

The Inspector General appears to suggest that the RRB is unwilling to make changes to adapt to changing circumstances. However, the record suggests otherwise. In recent years, the RRB has downsized significantly from approximately 1,700 full-time equivalent employees (FTE's) in the early 1990's to just over 1,000 FTE's at the present time. The agency's field service, the principal service delivery organization, was reduced in the 1990's from 86 to 53 offices. Automation has replaced human effort in performing many agency tasks, and on-line claims processing is just around the corner. Change is a fact of life, and the RRB has repeatedly shown it is fully capable to make changes as appropriate to further the agency's core mission.

The three-member Board that heads the RRB asked the agency's Executive Committee to conduct a detailed review of agency operations and organization and recommend possible changes that could be made to reduce costs while maintaining adequate customer service. With the assistance of an outside facilitator, the Executive Committee conducted several offsite meetings with the goal being to provide the Board Members with a set of recommendations and ideas for changes in agency organization and operations to meet the Board's directive. A detailed report was provided to the Board Members late this summer with recommendations addressing virtually every aspect of RRB operations. The Board Members are currently reviewing this report and will take actions where deemed appropriate.

Information Technology Security

The RRB identified information technology security as a material weakness and established an action plan to address this problem. The RRB has followed its action plan and resolved most of the security issues that gave rise to identifying information technology security as a material weakness. The remaining issues will be resolved in fiscal year 2005. In addressing the various

information technology security issues, the RRB has significantly strengthened its security staff and the security awareness of all RRB employees. While information technology security is, indeed, a challenge, it is a challenge that the RRB is meeting.